DOW THEORY LETTERS INC.

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THE MARKET: I have been writing over the past few months of the coming titanic battle between the forces of inflation and deflation. Wages are rising, interest rates are high, costs in general are rising, business is fiercely competitive foreigners are fighting to sell our markets (and succeeding), yet volume of sales is still high and consumers are still buying.

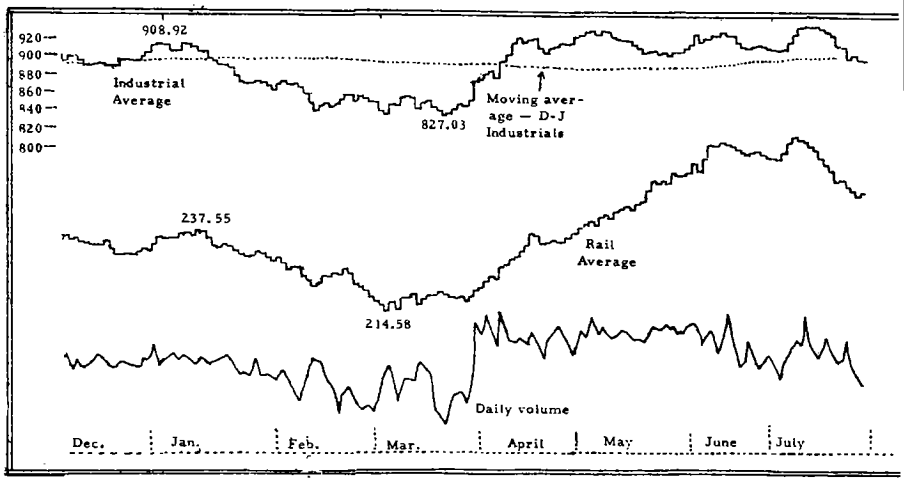
With 22 million people in the stock market, almost every American family has a stake in the direction which stocks will take. Millions of people's assets are tied up in equities, owned either outright or on margin. The tide of stock prices is doubly important today. First, because the stock market reflects the trend of coming events. Secondly, because people's personal fortunes are closely tied to the direction of the stock market.

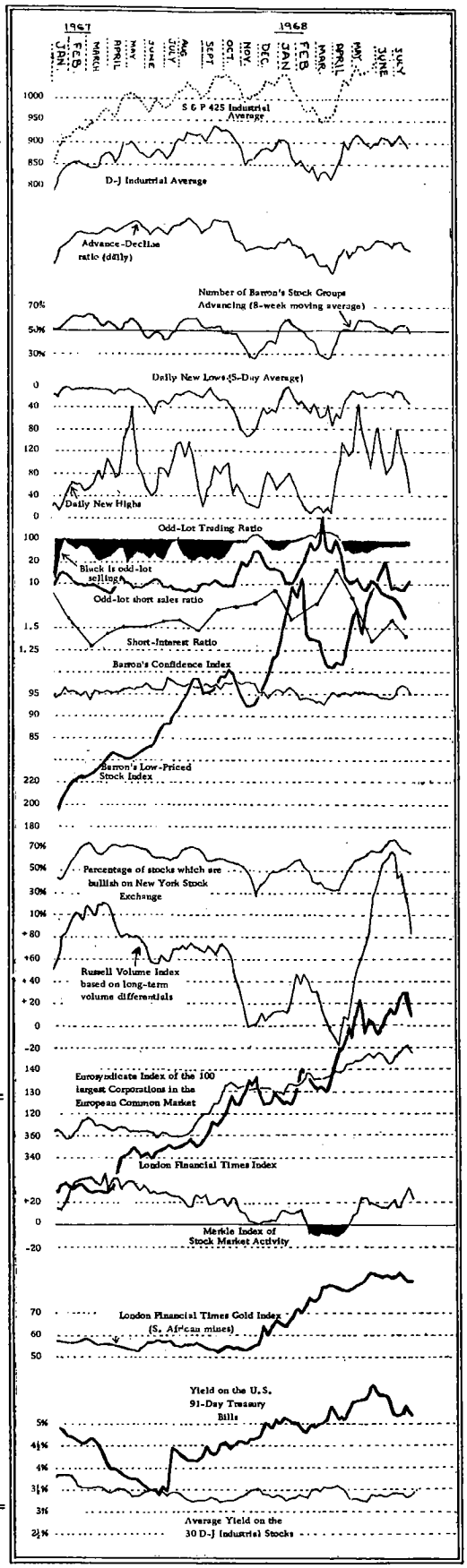
During the past few weeks the public has stared at Wall Street in stoney disbelief. Didn't all the experts say that the only place to hedge against inflation was the stock market. Didn't they promise new highs through the summer? But group after group has now suffered losses. Many of the glamour stocks have been severely battered. Cracks have begun to appear in the inflation arguments—in the very reasons for owning shares in inflation-bent America.

Currently, the world is in ferment and Wall Street is losing its confidence. What happens if Vietnam is not settled? Who is going to be our next President? Should the surtax really have been passed? Why hasn't the price of gold fallen through $35 an ounce as our leaders suggested it might do? What happens if consumers get scared and ease up on their buying? Could this really still be a primary bear market, could the 1966-67 and early 1968 action be the greatest upside fooler in bear market history?

If this is a primary bear market (and I have steadfastly maintained that it was) then the great primary trend of the market has been held back for over two years. The bear has been leashed and starved, but now the leash could be ripping asunder. By fall the bear could be running amuck, as all the pent-up forces of the primary bear trend are sent raging across Wall Street and the land.

As we look at the page 1 chart we notice (perhaps to our surprise) that there really was no summer rally. We note that the Industrials battered into the 920




1967
1968
S & P 425 Industrial Average
D-J Industrial Average
Advance-Decline ratio (daily)
Number of Barron's Stock Groups Advancing (8-week moving average)
Daily New Lows (5-Day Average)
Daily New Highs
Odd-Lot Trading Ratio
Black is odd-lot selling
Odd-lot short sales ratio
Short-Interest Ratio
Barron's Confidence Index
Barron's Low-Priced Stock Index
Percentage of stocks which are bullish on New York Stock Exchange
Russell Volume Index based on long-term volume differentials
Eurosyndicate Index of the 100 largest Corporations in the European Common Market
London Financial Times Index
Merkle Index of Stock Market Activity
London Financial Times Gold Index (S. African mines)
Yield on the U.S. 91-Day Treasury Bills
Average Yield on the 30 D-J Industrial Stocks

area four times, only to tumble back on each instance. By late July the Dow was sent reeling to its early April level. On July 29 the Dow closed slightly below its 200-day moving average (which now stands at 884) for the first time since April. Thus investor sentiment switched, and informed buyers were paying less for the 30 blue-chip Dow stocks then they were willing to pay on average during the last 200 days. As I said in the last Letter, any decisive cracking of the moving average will not bode well for the autumn season.

In fact, with the absence of the summer rise and the gathering weakness and strain, it would not surprise me to see the market in the throes of a full-fledged primary bear collapse between now and October. According to Dow Theory, we are still in a bear market, and as I have stated repeatedly, the Industrial Average shows an ominous pattern of declining tops during 1966, 1967 and 1968. Perhaps 90% of all investors never fully comprehend the theory and concept of the primary trend and the force of that trend. If the primary bear forces are indeed now enveloping Wall Street, we might easily expect the Dow to break the 1967 low (786) by October, with the funds, the professional and the public throwing over their shares in a frantic attempt to escape the winds of destruction which could be unleashed as the fury of a two-and-one-half year bear market finally emerges for all to see.

Technically, it is well to note that the Russell Volume Index (page 1 composite chart) dropped from 109 to 83 last week, a whopping decline of 26 points. Odd lotters eased up substantially on their selling. The Utility Average, despite declining interest rates, was moving down "in gear" with the other Averages, and the advance-decline line was confirming the Dow by dropping into April territory. A point-and-figure "sell signal" (see last Letter) was given as the Dow touched an hourly 895, another and stronger signal was provided when the Dow touched an hourly 885.

From the standpoint of strategy, subscribers know where I stand, and they have known ever since the bear market started. We are in a largely cash position with a 10% to 15% gold hedge, and we are adhering to the classic Dow Theory policy of avoiding all ups and downs, all foolers and deceptive moves as this primary bear market seeks to separate the public from its funds. A bear market will separate you from your money, given time, and this has been true throughout history. If this bear market is ready to cry "vengeance is mine," we can expect the public to be "cleaned" during the period ahead in a way which has not been seen in many a year.

Historically, when the forces of deflation are just around the corner, it is Wall Street which has deflated first. The rest of the nation and the economy follows in due time. I would guess that a severe market smash in 1968 would be followed by growing deflation, unemployment and business trouble in early 1969.

THE FACE OF DEFLATION: After much debate and hand-wringing, the Administration has finally got what it wanted. The 10% surtax has passed. Now people are beginning to study what it all means— and what lies ahead. First of all, the surtax will reduce consumer purchasing power at an annual rate of $6 billion or more. But this does not measure the full effect of the Since the surtax is retroactive to April 1, taxpayers will have to face the fact that they will be getting smaller tax refunds. This means that $3 billion will be cut from the spending stream during the first two quarters of 1969.

On top of the new surtax, social security payments are slated to go up, and the effect of that is that an additional $1.5 billion will be denied consumers. All in all, consumers are going to have considerably less to spend in 1969, unless they can make up their tax and social security losses with large wage raises.

In the economy, the rate of total sales (understandably, in the light of the above) is now slowing down. Because sales are slowing, inventories are building up. In June the rate of industrial plant utilization (which has been rather sluggish) dropped to 84.9%. Since industrial plants are far from using all their potential capacity, they are cutting back on new orders for plant and equipment. Thus orders for durable goods are contracting, and the latest figures show a 4.2% drop in durable goods orders during June.

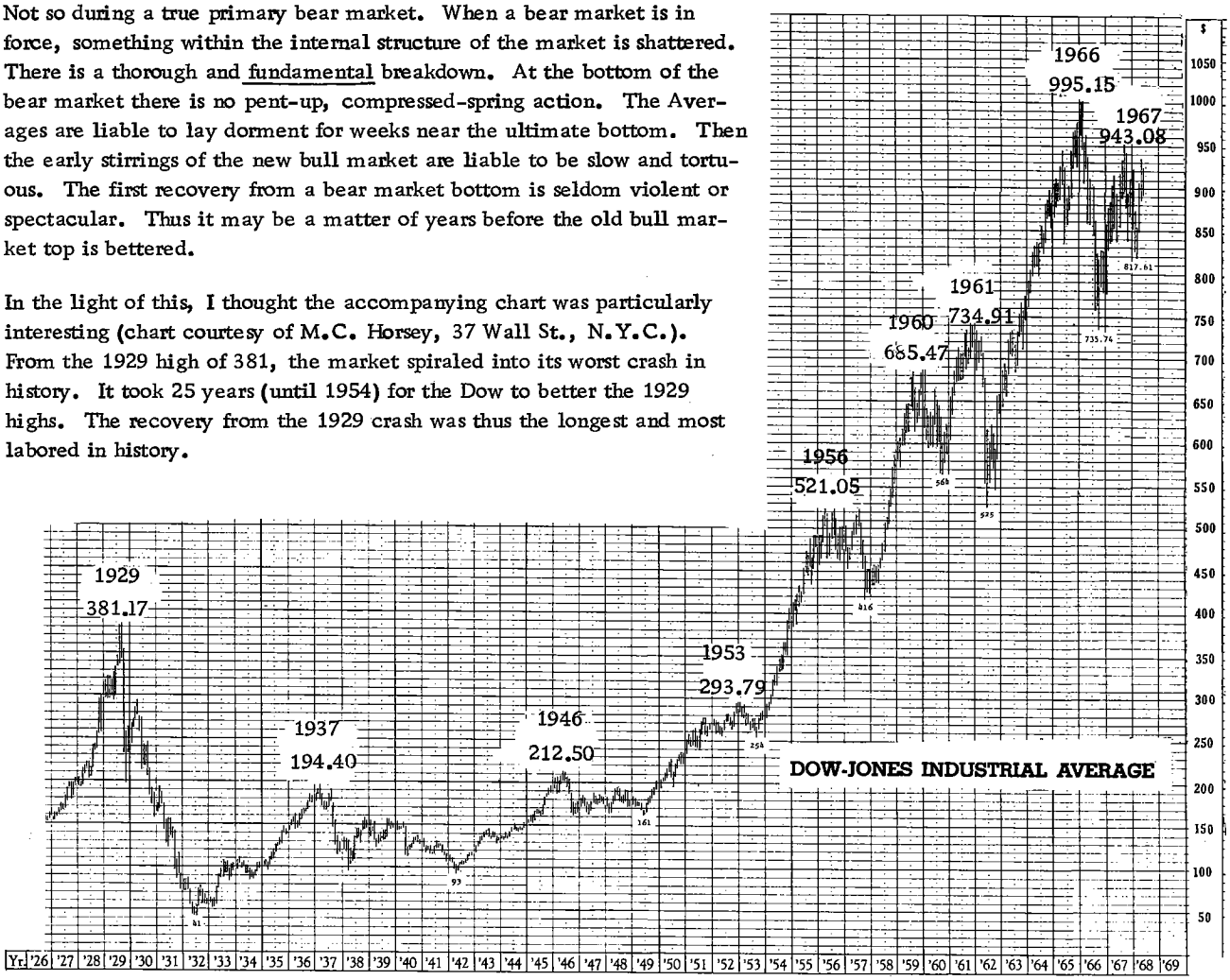
Over the past year everyone was telling everyone else about the dangers of inflation. The smart thing to do was to rush to the stock market and buy one of those fabulous "cat-and-dog" inflation hedges. Now, the public is over its head in stock certificates, and this is marvelous as long as the market behaves as if it wants to save everyone's buying power by inflating along with everything else.

But what happens if the market structure begins to crumble? What happens if all the inflation-hedge vehicles start to tumble? What happens if the reason (i.e. inflation) for buying all this stock starts to fade— or be questioned? For the truth is that every salesman, butcher and baker has accepted inflation as a way of life— and they are prepared for it. Houses are heavily mortgaged, amateurs are speculating in land, coins, stamps, what-have-you, and the stock market is loaded with millions of amateurs and $6 billion in margin accounts. To put it bluntly, the one thing that people are not ready for is deflation, even in small quantities. Because of this, if deflation comes it could contain the seeds of disaster.

TIME LAG: A primary bear market differs from a bull market reaction (downward correction) in many ways. Bull market reactions are usually fast and violent. Near the bottom of a bull market reaction, the market usually develops great technical strength. This technical strength can be likened to the strength which is built up when a spring is coiled. Consequently, when a bull market reaction is over, the recovery is generally rapid and powerful, and new highs can be expected within a period of months.

Not so during a true primary bear market. When a bear market is in force, something within the internal structure of the market is shattered. There is a thorough and fundamental breakdown. At the bottom of the bear market there is no pent-up, compressed-spring action. The Averages are liable to lay dorment for weeks near the ultimate bottom. Then the early stirrings of the new bull market are liable to be slow and tortuous. The first recovery from a bear market bottom is seldom violent or spectacular. Thus it may be a matter of years before the old bull market top is bettered.

In the light of this, I thought the accompanying chart was particularly interesting (chart courtesy of M.C. Horsey, 37 Wall St., N.Y.C.). From the 1929 high of 381, the market spiraled into its worst crash in history. It took 25 years (until 1954) for the Dow to better the 1929 highs. The recovery from the 1929 crash was thus the longest and most labored in history.



The recovery from the 1937 bull market high of 194.40 was also arduous. It took 8 years, following the 1937 crash, for the Dow to better the old 1937 peak. From the 1946 bull market high of 212.20, the Dow went into a bear market which lasted until 1949. It took 4 years, until 1950, for the Dow to better the 1946 peak.

In June, 1949, a great new bull market began. From then on, the quality of market recoveries which followed declines changed drastically. Following the 1953 correction, the Dow moved to new highs in a matter of 14 months. During 1956 and 1957 the Industrials formed a "triple top" in the 520 area. From the 1957 peak of 520.07, the Dow spilled to an October low of 419.79. Within 15 months the Dow (in late 1958) had rallied to new historic highs. From the 1960 peak of 685.47, the Dow reacted, then recovered to new bull market highs within 15 months. Again, from the 1961 peak of 734.91, the Dow reacted, then pushed to historic highs within 22 months.

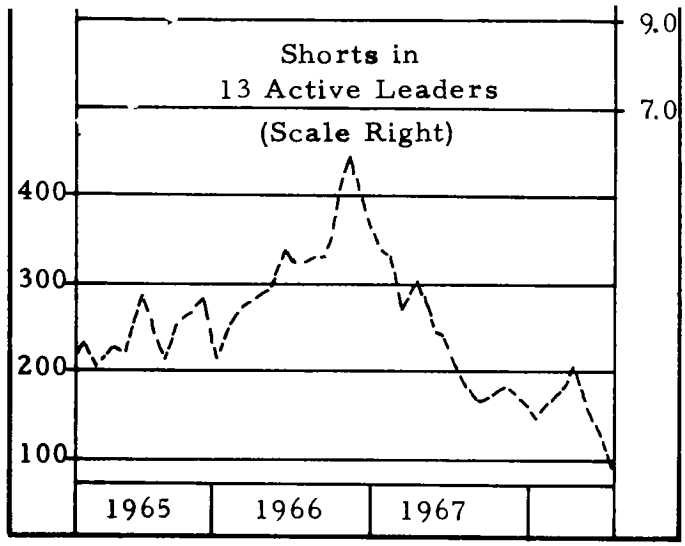
Now we come to the February 9, 1966 peak of 995.15. From that high, the Dow has established a series of declining tops which run like this: the 1966 high was 995.15, the 1967 high was 943.08, the 1968 high (so far) was 923.72 recorded on July 15. The fact is that two-and-one-half years have now elapsed since the 1966 high, and the Dow still shows no inclination to better 995.15.

This is not the way primary bull markets act. Bull markets do not correct, then mill about for two-and-one-half years without approaching the old highs. Bull markets do not form annual series of declining tops. The inference is that we have been in a fantastically deceptive bear market rally since October, 1966, and if this is true, time is running out rapidly for the optimists.

Let us look at it another way. If it is true that a bear market started on February 9, 1966, then the primary bear market recorded its low in October, 1966 at 744.32. Thirty months have passed since the 1966 top, the Dow has recorded lower peaks in each year since 1966, and the force of the bear has been pent-up. The longer the primary forces are held back,

the more drastic the action is likely to be when they finally express themselves. If so, we might expect the bear to make up for lost time during the period ahead.

SHORT INTEREST: As noted before, the short interest figures are now giving a deceptive picture regarding the underlying technical strength of this market. I include a chart put out by Garfield Drew (Drew Odd Lot Studies) showing the short interest in 13 active N.Y.S.E. leaders since 1965. These 13 stocks are important trading vehicles, the type of stocks usually shorted by professionals. Astonishingly, the latest reading shows that the total short interest in these 13 stocks has dropped to the lowest figure since 1962 (these short figures are properly adjusted for stock splits, a procedure not followed by the N.Y.S.E.).



Much of the short interest on the N.Y.S.E. is rendered deceptive by arbitrage operations, stock splits, transfer of new (highly shorted) stocks from the AMEX to the N.Y.S.E. Drew's chart points up some of this deception.

From another standpoint, it is most interesting to note that the combined short interest in the 30 widely followed Dow Industrial stocks hit a peak of 1.3 million shares in October, 1966. This figure pretty much corresponds with Drew's peak in his 13 actively-traded stocks. But the latest reading of the short interest in the 30 Dow Industrial stocks shows a drop to a low of 530 thousand, a whopping drop of 42% from the 1966 high. This huge drop in the Dow short interest bodes ill for the Industrial Average over the period ahead.

DEBUNKING: Over the past few months a great deal of hokum has been published in various services regarding the value of different stock averages. The basis of these assaults, of course, has been that the Dow has not performed the way the optimists would like it to perform. From 1949 to 1966, while the great bull market was on, the Dow Industrials led the market to new highs in a matter of months, following every reaction (see previous section). Therefore, there was no pressing need to debunk the Dow. Since the Rails lagged (particularly during the 1950's), it was the carrier Average which received the bulk of the criticism.

But with the failure of the classic Dow Industrial Average to push to new highs following the 1966 bull market peak, a torrent of criticism has been leveled at the Dow. If the Dow couldn't do what everyone wanted (and wouldn't confirm some of the other averages), what good was it?

I have asked my good friend Robert Powers, a brilliant teaching fellow at Cal-Western (and former security analyst at Bank of America) to try to set some of the thinking straight. I thought the following piece was extremely informative, and I present it as an exclusive to my subscribers.

WAR OF THE AVERAGES by Robert Powers

Over the last few years, the investment community has witnessed a "blowoff" in stock market averages. With the addition of the N.Y.S.E. Indices, the AMEX Index, and the Indicator Digest Average, the investor can now follow one average for every trading day of the month. As stock market averages have proliferated, competition for loyal followers of these averages has intensified. While occasional gunfights break out among disciples of the geometric averages and those who believe in the weighted arithmetic variety, most of the gunfire has been trained on the Grandaddy of all averages, the Dow.

"You're obsolete, you old fogey," the modern followers of the new "computerized" averages shout at Old Man Dow. "You haven't gone to a new high!" Actually, there are a few more rational complaints that could be laid at the Dow's doorstep: (1) It is mathematically unsound; (2) its components do not represent the "market". The former is undeniably true; the latter is a matter of opinion.

Before the jet-set of the investment community succeeds in burying the Dow, however, they should realize that their own "computerized" pets (that they have chosen to replace the Dow) have flaws of their own.

The Big Three in the geometric camp are the Value Line Averages, the American Investors Service Average (AISA), and the Indicator Digest Average (IDA). These mathematical wonders' claim to fame is: (1) They give a broad representation of the market (from 800 stocks in the AISA to all stocks on the N.Y.S.E. for IDA); (2) they weigh each stock equally. Because of

the above factors, however, these geometric averages have certain disadvantages. First, they are biased (in their weighting) towards fragmented industries, regardless of the size of the industry aggregate. For example: 3% of the AISA is represented by the motor freight carriers (an industry characterized by many small companies), while only 2.63% of the AISA is represented by the Auto, Aluminum, Tobacco, and Rubber industries combined! These industries suffer in the geometric average weighting system because they are comprised of a few very large companies. Secondly, the Big Three geometric averages are dominated by volatile stocks with small capitalizations, because all stocks are weighted equally. One could remove all of the Dow Industrials (a Who's Who in American Industry) from the IDA without greatly affecting the average!

When the N.Y.S.E. triumphantly announced its own composite index a few years ago, it came up with virtually the same dinosaur that Standard & Poors dragged out of the ground decades ago. In these weighted arithmetic averages, stocks are weighted by their capitalizations and combined arithmetically. Consequently, only those stocks with large capitalizations have any great effect on the index. For example, in June 1968, Jersey and United Airlines traded about the same number of shares. Yet, in a weighted arithmetic average, UAL would have to rise 200% to compensate for a 10% drop in Jersey. Jersey is the second largest industrial corporation in the USA, and United the second largest transportation company; but Jersey's capitalization is much larger than that of United.

What is the moral of the story? All stock market averages and indices have their flaws, and Let's Not Forget It.

DOW THEORY MARKET LABORATORY PAGE

The stock market, like ancient Gaul, can currently be divided into three parts. I have illustrated these three parts with six weekly charts (courtesy of Quote Digest, 110 N. Lorraine, Wichita, Kans.).

The first section, represented by the oils, is acting well. Investors searching intently for values, believe they have found them in the oils, and with the AFI big new oil discovery, the industry has found glamour. Thus AFI and J (see charts) are up on their highs for the year. The current weakness has not yet touched them.

The second group, represented by aluminums, is falling apart. Here costs have hit the industry and investors see nothing but trouble ahead. AA and KLU are 1/3 to 1/2 off their recent highs, and the bear forces are really taking hold here.

The third group, which encompasses many stocks on the board, is going with "the market." Ford and MMM pushed to highs for the year within the last month or two, and then the broad market weakness hit them. Both stocks have broken their short-term or 10-week moving average. These two issues, like the great majority of issues on the Board, can be expected to continue to go "with the market".

If the general market continues to show weakness, even the oils can be expected to get hit. As a rule, in a true bear market smash, everything goes, and the longer the "hold-out", the harder the "hit" when the hold-out stock finally buckle under the impetus of a primary bear trend.